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Financial Market Commentary: 4th Quarter Summary and Year Review 2013

"Prepare for the unknown by studying how others in the past have coped with the unforeseeable and the unpredictable." -- George S. Patton

2013 is in the history books and it was a fantastic year for U.S. equity owners. The S&P 500 Index is close to its 50-year average price/earnings ratio of 16; and there is extremely high levels of investment advisory optimism with investment advisor bears at a 26-year low of only 14.1% and investment advisor bulls at a six-year high of 59.6%. We can only hope that we have not reached a point of exuberance in the financial markets. While many equity investors are ecstatic about last year, it's important to make a couple of points: past performers seldom repeat in a logical pattern and there is no discernible pattern that would allow an investor or advisor to pick winners for 2014. Therefore, diversification is a prudent approach to take when investing. While it is likely a diversified portfolio will never be the best performer in any given year when compared with its constituent ingredients – it will never be the worst performer, either. For investors who now feel the need to own the big winner, the performance of a diversified portfolio may not be satisfying. But that's the rub as no one has the foresight, at year beginning, to know which asset class will be the winner at year end. As an investor it is important that we not criticize salsa for tasting different from sliced tomatoes. In the end, as it always turns out, diversification provides a winning combination of risk and return – but it requires that an investor allow sufficient time and adhere to patience in order for the portfolio to fully play out.

Yearly Financial Market Review

Q1: A Great Start to the Year

The US economy accelerated in early 2013 as credit conditions continued to improve. Investors displayed growing confidence in the Federal Reserve's ongoing support and the stock market posted strong returns. The S&P 500 Index generated a solid gain of 10.61% on a total return basis, a level not seen since October 2007.

The Fed vowed to continue its $85 billion per month bond-buying program – put in place to bring down long-term interest rates – until the unemployment rate falls to 6.5%, as long as inflation is stable. Low borrowing costs helped unlock consumer demand for cars, homes and consumer goods, setting the stage for improvement in employment, GDP and corporate earnings growth. Fears of a bond market "bubble" and an improving housing market brought a significant flow of money back into stocks.

A slowdown in Europe and a variety of country-specific issues dragged down Emerging Market performance during the quarter. Persistent economic weakness and the failure to meet deficit targets in France, inflation in Brazil, unemployment in Spain, near-financial collapse in Cyprus, wage pressure and weak manufacturing in China, worries about natural gas prices in Russia, and geopolitical instability around South Korea all had negative effects on the MSCI Emerging Market Index.

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Q2: To Taper, or Not to Taper?

Global stock markets have started each year since 2010 in optimistic moods only to run into trouble in late spring. That trend continued in 2013. Because of the ongoing US housing recovery, employment growth and improving measures of consumer activity, Fed Chairman Ben S. Bernanke suggested that the Central Bank might consider reducing the amount of Treasuries and mortgage debt it buys in 2013. Investors reacted to the potential loss of this support by selling stocks and bonds in unison, reversing strong gains that had been made at the beginning of the second quarter. This triggered a surge in interest rates and heavy losses for Treasury bond investors.

Every asset class generated flat to negative returns for the quarter. Emerging markets remained the worst performer as investors were caught off-guard by the continued recession in Europe, slowed growth in China, bond volatility in Japan, and large-scale political unrest in Brazil and Turkey. Commodities were the second worst asset class; gold prices fell 23% during the second quarter.

Q3: All Eyes on Washington, DC

US equity investors endured a volatile summer during the third quarter. In July, the S&P 500 Index hit a record high in response to improving economic results. However, by August the US equity market was retreating amid geopolitical concerns that included the potential for military intervention in Syria. Observers expected the political debate in Washington, DC over government spending and the debt ceiling to further harm the equity market, but the Fed surprised investors by announcing that it would delay tapering until signs of sustainable economic growth were evident. The 10-year Treasury yield immediately declined, but the S&P 500 rose again in September, showing a total return of 174% since the beginning of the financial crisis five years prior.

Meanwhile, economic activity outside of the US showed marked improvement. The recession in the Eurozone appeared to be coming to an end. China showed better economic results as manufacturing conditions improved. Tokyo gained a boost after being awarded the 2020 Olympics. Broadly speaking, global equity markets reacted positively to this and other news in the third quarter. Foreign developed and emerging markets advanced 11.6% and 5.8%, respectively.

Q4: A Strong Finish for 2013

The fourth quarter began inauspiciously with the US government experiencing a 16-day partial shutdown. The shutdown ended with a deal that raised the debt ceiling of $15.7 trillion. US equity markets responded with exceptional performances. Many indices reached new all-time highs and some even recorded their highest annual gains since the financial crisis. As of December 31, 2013, the S&P 500 Index has risen over 32.39% year-to-date.

Improving domestic indicators point to a stabilized economic recovery. Prominent examples of improvement include nonfarm payrolls, the unemployment rate and the housing market. As a result, US consumer confidence and spending have recovered and are now contributing to GDP growth.

The Fed announced on December 18, 2013 that it would start to reduce its bond purchases by $10 billion per month beginning in January 2014. The announcement is being perceived by investors to signal the beginning of a return to normal monetary policy and normal interest rates.

Global equity markets were strong over the quarter, supported by further signs of improvement from the UK, encouraging trade data from India, strong growth numbers from China, and German election results.

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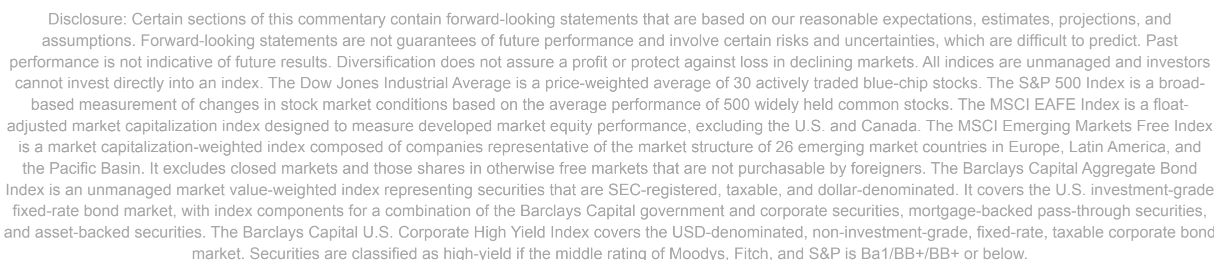
2014: The Return to Normal

As we enter 2014, we feel comfortable predicting that this year may be the year that brings things to normal - modest economic growth, low inflation, accommodative monetary policy, and solid corporate profitability.

The Fed's initial steps to taper the degree of its quantitative easing (QE) program should improve total returns for most investment grade and high yield corporate bonds if some gradual upward movement in Treasury yields across the yield curve is likely. As other major central banks continue to ease monetary policy further, the tapering and the relatively stronger economic growth prospects should also benefit the dollar. Stronger merger and acquisition deal activities in the US may also attract foreign capital inflows. While the great performance of the equity market in 2013 is unlikely to repeat in 2014, it may shift from "great" to "good" and can still move upward due to the Fed's pledge to keep short-term interest rates unchanged until employment falls below 6.5% is a positive sign.

Despite these optimistic projections, we expect the economy to continue to face uncertainty. In 2014, Janet Yellen will assume leadership of the Fed. The Fed's plans to gradually taper its bond-buying program are clear, but one major macroeconomic unknown is the timing of the Federal Reserve's eventual monetary tightening. Looking ahead, Ben S. Bernanke said, "It depends on the data." What he did was to deal with the financial crisis, while Janet Yellen developed some very creative monetary policies after zero-interest rate policy. Now she faces a situation where she has to unwind these policies back to normal without creating the next crisis. If she does not unwind quickly enough, investors' excess money will be inflationary and then interest rates may rise. On the other hand, if she is too aggressive in unwinding QE, a shortage of demand could push interest rates higher. Yellen faces a difficult task managing expectations about future tapering activities – both timing and magnitude – without negatively affecting economic growth.

After a strong 2012 and 2013, US corporate profit margins are near all-time highs. However, the rest of the world remains 20% below their peak. We will continue to recommend exposure to European and foreign developed markets. They are in earlier stages of economic recovery than we are and therefore will likely reshape investment opportunities. 2013 has been a hard year for fixed income investors; however we do not recommend abandoning fixed income asset class in our clients' portfolios. Portfolio risk control is the main concern, as most core bonds tend to have low correlation to equities.


Disclosure: Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Free Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moodys, Fitch, and S&P is Ba1/BB+/BB+ or below.

Equity Performance

Equity Index	Style	YTD Return As of 12/31/2013	1 Year Return As of 12/31/2013	3 Year Return As of 12/31/2013	5 Year Return As of 12/31/2013	10 Year Return As of 12/31/2013
Russell 1000 TR	U.S. Large Cap Stocks	33.11%	33.11%	16.30%	18.59%	7.78%
Russell MidCap TR	U.S. Mid Cap Stocks	34.76%	34.76%	15.88%	22.36%	10.22%
Russell 2000 TR	U.S. Small Cap Stocks	38.82%	38.82%	15.67%	20.08%	9.07%
MSCI EAFE NR	Foreign Develop Stocks	22.78%	22.78%	8.17%	12.44%	6.91%
MSCI EM NR	Foreign Emerging Stocks	-2.60%	-2.60%	-2.06%	14.79%	11.17%
DJ US Real Estate TR	Real Estate	1.77%	1.77%	8.68%	16.34%	7.38%
DJ UBS Commodity TR	Commodities	-9.52%	-9.52%	-8.11%	1.51%	0.87%

Fixed Income Performance

Fixed Income Index	Style	YTD Return As of 12/31/2013	1 Year Return As of 12/31/2013	3 Year Return As of 12/31/2013	5 Year Return As of 12/31/2013	10 Year Return As of 12/31/2013
BarClays US Aggregate Bond TR	U.S. Core Bonds	-2.02%	-2.02%	3.26%	4.44%	4.55%
BarClays US Corporate High Yield Bond TR	U.S. High Yield Bonds	7.44%	7.44%	9.32%	18.93%	8.62%
BarClays Global Aggregate Bond TR	Foreign Developed Bonds	-2.60%	-2.60%	2.39%	3.91%	4.46%
Morningstar Emerging Market Bond	Foreign Emerging Bonds	-2.81%	-2.81%	3.94%	16.70%	7.88%
CitiGroup 3-Month T-Bill	Cash	0.05%	0.05%	0.07%	0.10%	1.59%

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